March 30, 2012

"On balance, an assessment of a broad range of indicators suggests that a substantial portion of the decline in the unemployment rate does reflect genuine improvement in labor market conditions."
-BEN BERNANKE

POINTS TO PONDER

1. Wall Street seems to have at best mixed feelings toward the Obama administration despite the fact that stock prices during its first term have had their fifth highest return compared to any president since 1913. Of course, like FDR, Mr. Obama was sworn in after a vicious bear market but, unlike during the New Deal, economic growth has been close to the worst experienced during all administrations.

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2. Financial markets remain upbeat about US economic prospects, including unemployment. The Fed, however, is noticeably more restrained. Emphasizing a point made in past EVAs, the president of the NY Federal Reserve noted in a recent speech that had the labor force participation rate remained at 66% (where it was in 2008), versus today's 64%, the official unemployment rate would be over 10%.

3. A still sputtering economy and the burden of extremely generous retirement packages are causing state and local governments to borrow from the same pension plans they are supposed to be funding. The state of New York is projected to borrow $1.4 billion from its pension system between this fiscal year. Numerous other cities and counties in the Empire State are also engaging in this highly questionable accounting gimmickry.

4. Boston-based Dalbar is the leader in tracking mutual fund investor performance and its latest analysis of 2011 results tells a familiar story. Although the US stock market actually rose slightly last year, the average equity mutual fund investor lost 5.7%. Dalbar attributes this to heavy redemptions during last year's steep, but brief, sell-off.

5. FedEx, a bellwether of both domestic and international economic vitality, recently lowered its forecast for global growth to 2.3% from 2.9% for 2012. Even in the US, the shipping giant reported that express business fell by 4% in its most recent quarter.

6. In addition to the cautious forecast from FedEx, looking at a variety of key cyclical measures reveals an economy that is far from booming.

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7. A key area that has the potential to continue supporting the economy is auto sales. The average age of the typical car has risen dramatically over the last few years, implying that the recovery seen by automakers over the last couple of years could be in its early stages.

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8. According to the Institute for Energy Research, the US has 800 billion barrels of recoverable oil from shale formations. This is three times the proven reserves of Saudi Arabia. However,

much of this is on federal lands that may not be accessible for political and environmental reasons.

9. Tensions with Iran and perceptions of an improving global economy are keeping the critical Brent crude price above $120. However, the International Energy Agency (IEA) estimates that the present surplus oil-producing capacity is 4 million barrels per day (mb/d), rising to 8 mb/d by 2016. The IEA has also lowered its forecast of annual demand 20 years from now from 130 mb/d to 100 mb/d.

10. Although the US economic recovery has been one of the most muted on record, it still compares favorably with its developed country peers. In fact, only Canada has seen stronger (or less feeble) growth since the end of 2007. Additionally, the US is the only rich nation whose economy is accelerating, however modestly.

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11. Japan's Fukushima disaster seems to have had little impact on the world's overall desire to build new nuclear power plants.   There are now 60 nuclear reactors being installed globally, with another 163 ordered or in the design phase. This compares to 62 and 156, respectively, prior to the Fukushima earthquake and tsunami.

12. There are winners in the wake of every crisis and Europe's banking debacle is no exception. Asian banks' share of trade finance was just 7% in 2006 and only 11% as recently as 2010. But as European financial institutions have retrenched, their Asian counterparts have increased their share to 16% as of last November, and it is likely even greater today.

13. Hopes were running high a few weeks ago that the Eurozone economy was stabilizing. However, the latest data show even German manufacturing output contracting, as well as renewed weakness in France. Similarly, Europe's critical Purchasing Managers Index (PMI) has turned down again. Consequently, a recession appears extremely probable, aggravating already disastrously elevated unemployment.

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14. Europe's fastest growing economy in the first half of 2011 was Ireland, led by surging exports. Sadly, this revival did not last as the Emerald Isle fell back into recession in the last two quarters of the year.

15. There is growing evidence that China's economy is slowing down more than originally anticipated. A major challenge for it in the years ahead is that future export growth will almost certainly be dramatically lower. Hong Kong-based GaveKal Research is forecasting that its annual export growth rate, which has averaged 30% per year over the past 20 years, will slow to 3% to 4%.

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The ABCs of EVAs. An email I received lately from a relatively new EVA reader caused me to realize that it's been awhile since I explained our process. And based on the fact that we've added a considerable number of new recipients, a review is probably even more in order.

First, every other week (thus, twice a month) we run what we call our "Points to Ponder" version. This is meant to be roughly similar to the front page overview on the *Wall Street Journal* called "What's News." As with that column, we try to follow the Jack Webb approach from the old *Dragnet* TV series: "Just the facts, ma'am." Each Points to Ponder (PTP) issue is a collection of factoids and charts that I've come across in my recent reading that I feel are particularly interesting or meaningful.

Second, once a month, we run a "guest" EVA, featuring an article or essay I also believe is particularly compelling. Sometimes the views expressed in these are not consistent with my own, but I feel it's important for readers to see a variety of opinions and outlooks. In the introduction I create for these, however, I do give a sense of where I agree and disagree with the guest author.

Then, one week a month, I write a full-length issue in narrative form that is heavy on my personal beliefs about what is transpiring in the economy, the financial markets, and the increasingly intrusive world (or netherworld) of politics. If nothing else, these are meant to provide a realistic view of the often nonsensical behavior of Wall Street, the financial media, and, of course, our elected representatives. Given the subject matter and the cast of characters, a fair amount of humor, often of a sardonic nature, is unavoidable.

Regarding the PTP version, which this week's EVA obviously is, we've also received some feedback asking us to interpret the various factoids we've included. Frankly, I've got mixed feeling about doing so because it is contrary to the objective tone I've always tried to maintain in the PTP format.

But I realize that frequently we highlight an amalgam of items that are upbeat, mixed, and negative; consequently, in my attempt to be fair and balanced (unlike, it often seems, much of the mainstream media), I risk a degree of confusion. In fact, that is the world we have to cope with as money managers; rarely, if ever, is the overall situation clear and unambiguous.

As a result, I've started to add some ending commentary to the PTP issues in the interest of clarity. Readers, of course, are always free to disregard my views, which I'm sure many do on a regular basis (I'm getting that disregarded feeling more frequently these days as my correction call continues to be at odds with a bubbly market).

This week is a classic case in point when it comes to dueling data. Even the Fed is highly conflicted, as indicated by the opening quotation from Ben Bernanke contrasting to the comments from New York Fed president Bill Dudley. My best analysis of what they are saying, and from dissecting the actual numbers, including adjusting for the non-winter this year, is that the labor market is clearly improving but it remains exceptionally weak for this stage in a recovery.

In fact, that's a good summation of how I see the economy in general: on the mend but still extremely fragile. As rock star economist David Rosenberg recently pointed out, the fact that the US GDP only grew 1.7% in 2011 despite virtually zero short-term rates, trillion dollar federal deficits, and a Fed that has tripled its balance sheet (essentially fabricating $1.6 trillion) is actually quite disappointing.

Typically, the second year of a recovery sees 5% GDP growth with much less reliance on performance-enhancing substances. And further indicating that headline numbers might be out of touch with reality, David also noted that the number of food stamp recipients is rising at a 400,000 per month rate.

Of course, the markets care most about what lies ahead, which is why FedEx's downward growth forecast revision caught my eye. And I do see mounting evidence of the recession in Europe intensifying, which is definitely not an outcome for which the raging bulls on Wall Street are properly positioned.

One other note of caution: We are moving into the time of the year when the market struggles. "Sell in May and go away" certainly doesn't work every time but following that advice the last two years would have been highly rewarding, as it has been on balance going all the way back to the 1920s. I wouldn't ignore its admonition this year, either.

David_Hay_Signature

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